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Foreign institutional investors and dividend policy: Evidence from China

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ABSTRACT

This study examines whether foreign institutional investment influences firms' dividend policies. Using data from all domestically listed nonfinancial firms in China during the period of 2003–2013, we find that foreign shareholding influences dividend decisions and vice versa.

Furthermore, changes in dividend payments over time positively affect subsequent changes in foreign shareholding, but the opposite is not true. Our study indicates that foreign institutional investors do not change firms' future dividend payments once they have made their investment choices in China. Moreover, they self-select into Chinese firms that pay high dividends. Our evidence suggests that in an institutional setting where foreign investors have tightly restricted access to local securities markets and a relatively high risk of expropriation by controlling shareholders exists, firms can use dividends to signal good investment opportunities to foreign investors.

1. Introduction

One important manifestation of the increasing integration of the global economy in the past several decades has been the gradual opening of developing countries' securities markets to international investors. In response to this trend, foreign institutional investment has proliferated in emerging markets. While the growth potential of corporations in these markets offers a tantalizing prospect of high returns, foreign investors face information disadvantages because of geographic distance, language barriers, and cultural differences. Further, many emerging markets are characterized by weak protection of minority shareholder rights, and foreign investors' exposure to the risk of expropriation by controlling shareholders gives them a strong incentive to be vigilant in protecting their investments. This raises the question of whether foreign investors play an active role in the corporate governance of local firms.

This study addresses this question by examining the relationship between foreign investors and the dividend policies of Chinese listed firms. In November 2002, China partially opened its domestic stock market to foreign institutional investors by launching a scheme assigning investment quotas to qualified foreign institutional investors (QFIIs) that were officially approved by the China Securities Regulatory Commission (CSRC). Since then, the system has been gradually expanded, and by the end of 2015, 294 international financial institutions had QFII status in China. Because of the quota scheme, foreign institutional investors do not play as large a role in the Chinese stock market as in other emerging markets that have a more liberal approach to foreign investment. For example, only 1.4% of A shares were held by QFIIs in 2012 (Jiang & Kim, 2015). Therefore, one may expect that foreign institutional investors in China are dispersed outsiders who do not have the incentive or power to exert oversight over the firms in which they invest. However, some studies find evidence that foreign investors stabilize the Chinese capital market (Han, Zheng, Li, & Yin, 2015) and play an effective monitoring role in the corporate governance of state-controlled Chinese firms (Huang & Zhu, 2015). While the literature on the impact of foreign shareholding in other emerging markets that are more open to foreign investors is growing (Baba, 2009; Buckley, Munjal, Enderwick, & Forsans, 2015; Desender, Aguilera, Lópezpuertas-Lamy, & Crespi, 2014; Jeon, Cheolwoo, & Moffett, 2011; Kim, Sul, & Kang, 2010), the role of foreign institutional investors in China is not well known.

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The corporate governance literature shows that the principal–principal agency problem is pronounced in developing countries such as China (Claessens & Fan, 2002; Jiang & Kim, 2015; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Song, Wang, & Cavusgil, 2015). The Chinese institutional environment is characterized by weak investor protection, concentrated ownership structures, and high levels of government and political influence (Claessens, Djankov, & Lang, 2000; Chen, Chen, Schipper, Xu, & Xue, 2012; Fan & Wong, 2002). As a result, the controlling shareholder (usually a state-owned entity) of a Chinese listed firm is likely to have both the power and the incentive to divert corporate resources from minority shareholders and extract private benefits of control. Unlike their local counterparts, foreign institutional investors do not face political pressure to facilitate state shareholders' expropriation of wealth from minority shareholders (Firth, Lin, & Zou, 2010; Huang & Zhu, 2015) and are unlikely to have potential business ties with the listed firms they have invested in (Firth et al., 2016). Thus, foreign institutional investors are independent and can therefore theoretically be more effective at monitoring controlling shareholders. Research shows that dividends play an important role in disciplining managers and mitigating agency conflicts between insiders (e.g., managers and controlling shareholders) and outside minority shareholders. Dividend payouts to shareholders reduce the amount of cash under insiders' control and consequently limit the opportunities for insiders to spend cash inefficiently or divert it to themselves at the expense of outside shareholders (Easterbrook, 1984; Jensen, 1986). Thus, we argue that foreign institutional investors can induce managers to pay out dividends.

In addition to the proactive role of monitoring managers, dividends can function as a substitute for poor legal protection of shareholders (La Porta et al., 2000). This is particularly relevant in the Chinese setting. Foreign institutional investors investing in Chinese listed firms experience significant information asymmetry because of the geographical, institutional, and cultural distance they face. However, they are typically large and sophisticated institutions with resources and skills that allow them to collect value-relevant information and invest their holdings prudently (Gul, Kim, & Qiu, 2010). Having limited knowledge of local conditions, such investors may be particularly sensitive to signals of firm governance quality. They will prefer to invest in well-managed firms that have a reputation for equitable treatment of shareholders. Following this line of thought, we argue that Chinese listed firms can use dividend payouts to establish a reputation for moderation in expropriating the wealth of outside investors and thereby attract foreign institutional investment.

Using data from 1592 publicly listed Chinese firms during the period of 2003–2013 (14,706 firm-year observations), we find a significant positive association between foreign shareholding and dividends. Moreover, our simultaneous equation models using the generalized method of moments (GMM) method show that foreign shareholding influences corporate dividend payouts, and vice versa. Thus, in an institutional environment with weak investor protection, foreign shareholding and dividends are jointly determined and influence each other in a positive manner. Furthermore, we study the relationship between changes in dividends and changes in foreign shareholding. We find that firms that increase their dividend payments will subsequently have a larger proportion of foreign institutional shareholdings. By contrast, there is no significant effect of a change in the shareholding of foreign institutional investors on subsequent dividend payments. This suggests that foreign investors self-select into firms paying higher dividends.

This study contributes to the literature in several ways. First, while a substantial body of literature exists on the impact of international ownership on corporate governance, prior research centers on governance aspects such as firm restructuring (Ahmadjian & Robbins, 2005), dismissing poorly performing CEOs (Aggarwal, Erel, Ferreira, & Matos, 2011), board monitoring (Desender et al., 2014), firm performance (Douma, George, & Kabir, 2006; Aggarwal et al., 2011), and ownership (Leuz, Lins, & Warnock, 2009). The relationship between foreign institutional investment and corporate dividend policy has received less attention. This oversight is remarkable because dividends, unlike accruals, cannot be easily falsified or manipulated. Therefore, they are an attractive variable to study, particularly in emerging markets, which are often characterized by unreliable accounting and auditing practices.[1]

Second, in the small but growing literature on the impact of foreign institutional investment on corporate dividend policy in emerging markets, existing studies imply that foreign investors enhance monitoring and improve corporate governance quality in countries that have poorly developed legal institutions (Baba, 2009; Desender et al., 2014; Jeon et al., 2011; Kim et al., 2010). While these insights are valuable, they are mainly based on studies focused on Japan and Korea. To the best of our knowledge, our study is the first to examine the impact of foreign institutional investors on dividend policy in China, where foreign investors' access to local securities markets is more tightly restricted and a relatively high risk of expropriation by controlling shareholders exists. Recently, Huang and Zhu (2015) find that foreign institutional investors may play a beneficial role in limiting expropriation by controlling shareholders in China. Consistent with Huang and Zhu (2015), our findings support a positive influence of foreign shareholding on dividend payments. More importantly, our findings suggest that foreign investors tend to prefer investing in Chinese listed firms that already have more generous payout policies. In this way, our study complements the existing literature on the impact of foreign institutional investment in emerging markets and presents an alternative interpretation to the one offered by Huang and Zhu (2015).

Finally, while prior studies examining the relationship between dividend policy and institutional ownership focus mainly on the U.S. and other developed markets (Grinstein & Michaely, 2005; Short, Zhang, & Keasey, 2002),[2] the potential impact of institutional ownership in China has been comparatively neglected. Given the continuous growth of China's economy and ongoing development of its capital market, the role played by institutional investors in China can no longer be ignored. Recently, Firth et al. (2016) find that mutual funds, an important type of institutional investor, influence firms to pay higher dividends in China. Although the findings are interesting, they do not differentiate the effects of foreign and domestic investors. This study complements Firth et al. (2016) by showing that foreign institutional investors investing in Chinese listed firms under the quota scheme have different incentives to monitor firms and influence their dividend payouts, as compared to their domestic counterparts. Moreover, foreign institutional investors are more attracted to dividend increases than their domestic counterparts.

The remainder of this paper proceeds as follows. In Section 2 we review prior literature on dividend policy and develop our

[1] In China, for example, there have been several examples of publicly listed firms having used inaccurate bank statements (with or without collusion of the bank in question) to deceive auditors. In fact, contrary to intuition, faking cash balances seems to be one of the easier ways to distort corporate accounts. For an egregious example, see Deloitte's resignation letter to Longtop Financial Technologies from May 2011, which is registered with the SEC: http://www.sec.gov/Archives/edgar/data/1412494/000095012311052882/d82501exv99w2.htm (retrieved on January 31, 2016).

[2] We thank an anonymous referee for drawing our attention to the relevance of these articles to our study.